

The finalisation of 2017 and the output floor

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After the core of Basel III had been agreed, the Committee turned to the calculation of risk-weighted assets. Studies conducted by the Committee itself from 2013 onwards showed large and unexplained differences in the risk weights that banks calculated with their internal models for comparable portfolios. In some hypothetical portfolio exercises, the capital ratio of a bank could vary by several percentage points depending on which bank's model was used. Such variability undermined confidence in reported ratios and suggested that some banks used their models to minimise capital.¹

The work that followed was long and politically fraught. European banks, which relied more heavily on internal models and held large portfolios of low-risk mortgages, feared considerable increases in their requirements, whereas US supervisors pressed for constraints on model use. The negotiations stalled in early 2017. The Group of Central Bank Governors and Heads of Supervision, the Committee's oversight body, eventually endorsed the package on 7 December 2017 under the title "Basel III: Finalising post-crisis reforms".² The industry quickly began to call it "Basel IV", a label that the Committee has consistently rejected.

The package revised the standardised approach for credit risk to make it more risk-sensitive, including a more granular treatment of residential real estate based on loan-to-value ratios. It removed the advanced IRB approach for exposures to large corporates and banks and the IRB approaches altogether for equity exposures, while input floors were introduced for the parameters that banks estimated themselves. Besides revising the framework for credit valuation adjustment risk, the package replaced all existing approaches for operational risk with a single new standardised approach.³

The most consequential element was the output floor. Under it, the risk-weighted assets calculated by a bank with its internal models may not fall

below 72.5 per cent of the risk-weighted assets that would result from the standardised approaches. The floor was to be phased in from 50 per cent in 2022 to 72.5 per cent in 2027. When the COVID-19 pandemic broke out in March 2020, the GHOS deferred the implementation date of the whole package by one year to 1 January 2023, with the floor reaching its full level in 2028.⁴ The output floor binds above all for banks with large portfolios of low-risk-weighted mortgages and corporate loans, which explains why it was so contested in Europe and in the Nordic countries.

1 Notes

1. Basel Committee, Regulatory Consistency Assessment Programme (RCAP) – Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book (July 2013) and the corresponding report on the trading book (January 2013). To be verified. ↩
2. Basel Committee, Basel III: Finalising Post-Crisis Reforms (December 2017); press release of the GHOS of 7 December 2017. To be verified. ↩
3. Basel Committee (2017), sections on the standardised approach for credit risk, the IRB approach, the CVA framework and the new standardised approach for operational risk. To be verified. ↩
4. Basel Committee (2017), output floor section; GHOS press release Governors and Heads of Supervision Announce Deferral of Basel III Implementation to Increase Operational Capacity of Banks and Supervisors to Respond to Covid-19 (27 March 2020). To be verified. ↩

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